Research Report on Cyprus

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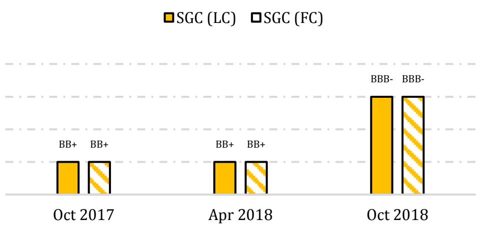
Ratings

Sovereign Government Credit (LC)	BBB-
Sovereign Government Credit (FC)	BBB-
Outlook (LC)	Stable
Outlook (FC)	Stable

* These ratings are unsolicited

Ratings dynamics



Main Economic Indicators of Cyprus

Macro indicators	2015	2016	2017
Gross gov. debt, EUR bn	19,1	19,4	18,7
Nominal GDP, EUR bn	17,7	18,1	19,2
Real GDP growth, %	2,0	3,4	3,9
Gross gov. debt/GDP, %	107,5	106,5	97,6
Deficit (surplus)/GDP, %	-0,2	0,4	1,8
Inflation rate, %	-0,5	0,1	-0,4
Current Account Balance/GDP, %	-	-	-6,7
External debt, USD bn	-	-	130,3*

Development indicators	2017
Inequality adj. HDI	0,77
GDP per capita, USD th	37,0

Default indicator	05.10.2018
7Y Gov Bond Yield, %	1,1

Source: RAEX-Europe calculations based on data from the IMF, WB, Ministry of Finance, UN, Deutsche Boerse. * Figure for 1Q 2018

Summary

The upgrade of Cyprus' SGC ratings to 'BBB-' reflects the consistent and sustained improvement in fiscal metrics resulting in an improved budgetary position and lower government debt levels. Furthermore, economic output has been solid and stable, the unemployment level continues to constantly decline and the positive net FDI figures show the improved attractiveness of the Cypriot economy for foreign investors. Moreover, the asset quality of the banking system continues to improve as a result of the government's intervention in Cyprus Cooperative Bank (CCB). Finally, we consider that the dependence of Cyprus on foreign aid has been substantially reduced since they left the three-year economic adjustment program from the European Stability Mechanism (ESM) and the IMF; since then, public finances have remained fairly stable.

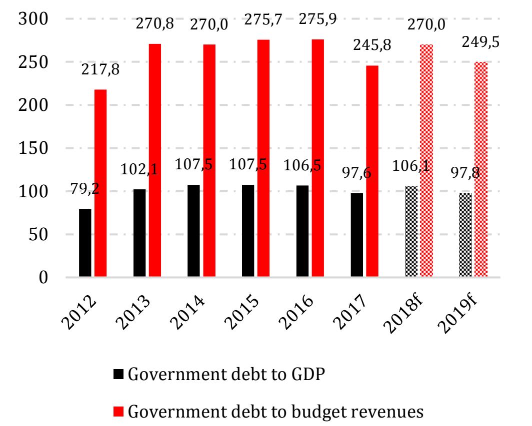
However, we still consider the banking sector risk as the key threat to Cyprus' creditworthiness. Moreover, despite improving, we continue to consider public and private leverage levels to remain substantially high.

Government debt metrics declined further. As of end-2017 government debt reached EUR 18,7 bn and stood at 97,6% of GDP. This is the first time since 2012 that ratio drops below 100%, mostly driven by regular fiscal surpluses and strong GDP growth. However, we expect the indicator to rebound and increase up to around 106% in 2018 as a result of the bond issuance of around EUR 2,5 bn in order to inject capital to the troubled CCB (see graph 1). The Agency considers this as one-time effect and, thus, it will only have a short-term impact on debt levels. As a consequence, we anticipate debt levels to continue their downward trend as of 2019 driven by expected consistent growth in economic output and increasing fiscal surpluses.

The debt structure remained favorable; as of 1H 2018 short-term debt stood at 4,5% of total debt. Only 3% of the total debt was issued in foreign currencies and 54% was in the form of official loans as of 1H 2018 (4% and 61% in 2017 respectively). The share of debt with floating interest rate slightly dropped and accounted 41% of total debt as of 1H 2018, 5p.p. lower compared to end-2017 when it stood at 46%.

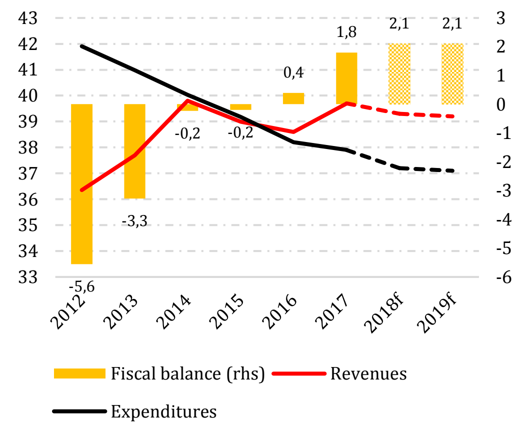
Budget balance was positive in 2017 and we anticipate surpluses to continue. The fiscal surplus in 2017 stood at 1,8% of GDP compared to a

Graph 1: Government debt dynamics, %



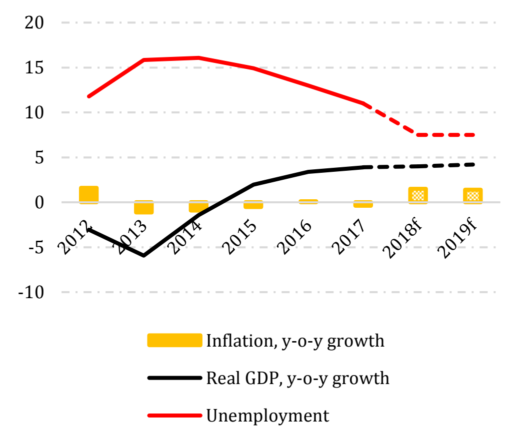
Source: RAEX-Europe calculations based on data from the IMF

Graph 2: Fiscal budget dynamics, % of GDP



Source: RAEX-Europe calculations based on data from the IMF

Graph 3: Macroeconomic indicators, %



Source: RAEX-Europe calculations based on data from the IMF

surplus of 0,4% a year before (see graph 2). This was driven by the implementation of a strict fiscal policy which saw expenditures-to-GDP drastically decline for the past seven years. On the other hand, revenues have been stable and they increased in 2017 due to higher VAT taxes – resulting from better economic conditions – and higher social contributions. Favorable fiscal developments continues in 1H 2018 as the budget balance marked a surplus of around 1,7% of GDP compared to a surplus of 0,4% of GDP in 1H 2017. On the revenue side, the surplus was driven by the increase of revenues from taxes on production and imports as well as on income and wealth, due to the increase in the employment levels and salaries. Favorable labor market conditions also contributed additionally to boost social contributions. The expenditure also grew but at a slower pace compared to the revenues. Segments which drove the increase were state employees wage increase, intermediate consumption, social transfers and subsidies. Large fiscal surplus underpins Cyprus' encouraging debt dynamics. Nevertheless, additional pressure on public finances might arise with the implementation of the health system reform which, in the long run, can result in higher expenditure due the demographic trends and termination of the agreement which bounds public sector wage growth to nominal GDP growth in 2018.

Macroeconomic position improved further. The Cypriot economy grew by a strong rate of 3,9% in 2017 (3,4% in 2016) with domestic demand as the key driver. Due to lower unemployment figures, private consumption increased driving imports to hike. Growth in seasonally adjusted terms continued in 2018 driven by sectors such as manufacturing, construction and tourism. We expect the Cypriot economy to continue its positive performance and to grow at a pace of around 4,0% in 2018 (see graph 3).

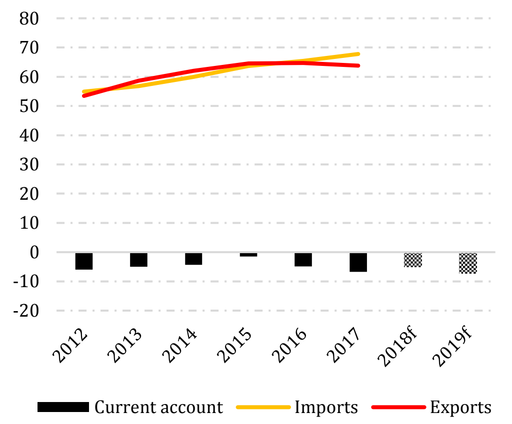
The unemployment rate continued to decline and reached a record low of 7,7% in 2Q 2018 (11% as of end-2017), driven mostly by seasonal employment, but still remaining below its peers' average[1]. The jobless rate among youth was 17,9%. We expect the overall unemployment figure to continue its gradual decline driven by positive economic growth (see graph 3).

The annual HCPI stood at -0,4% in 2017. In 2018 it turned to positive territory and stood at 2,5% as of August mostly driven by increases in prices of utilities, food and beverages and transportation. We expect inflation to reach around 1,5% as of end-2018 (see graph 3).

Competitiveness is moderate, external positon remains challenging. Gross external debt quite elevated and reached EUR 108,5 bn as of 4Q

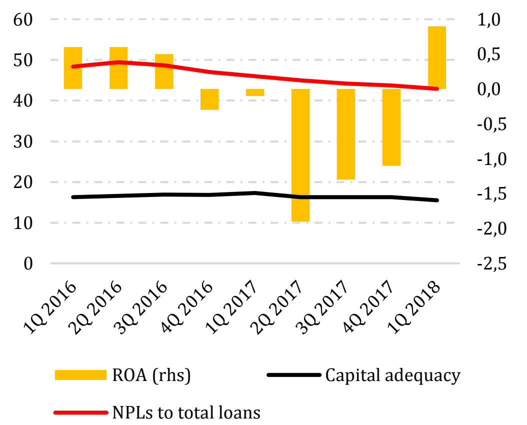
[1] Cyprus peers include the "peripheral Eurozone" countries such as Portugal, Italy, Spain and Greece.

Graph 4: External sector indicators, % of GDP



Source: RAEX-Europe calculations based on data from the IMF and WB

Graph 5: Financial soundness indicators, %



Source: RAEX-Europe calculations based on data from the Central Bank of Cyprus

2017, accounting for as high as around 565% of GDP. However, this figure shows a decline of around 20p.p. as compared to 2016. Moreover, external debt levels have been constantly declining in absolute terms in 2018; as of 2Q 2018, the reading was at EUR 101,2 bn, EUR 7,2 bn lower than end-2017 or a decline of 7%.

The trade deficit widened to -4% of GDP in 2017, 3,2p.p. wider than the metric posted in 2016. The increase was driven by higher imports of goods, mostly ships and aircrafts. The overall current account balance worsened in 2017 with a deficit of 6,7% of GDP (see graph 4). These figures include so-called SPEs (special purpose entities) in the shipping industry operating in Cyprus, but not the integral part of the real Cypriot economy. Excluding these entities from the current account transactions, the deficit stood at 1,5% of GDP in 2017 according to the Ministry of Finance.

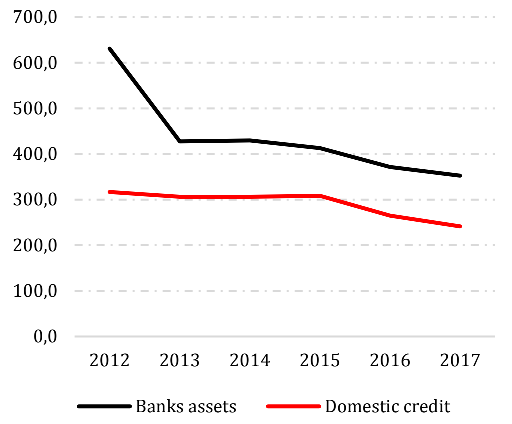
FDI inflow reached 48% of GDP in 2017, as Cyprus is an attractive investment destination due to its favorable tax regime. However, the special citizenship-by-investment scheme is driving the high level of FDIs which are primarily in the real estate sector.

The net international investment position (NIIP) of the country improved further as of 1Q 2018 when it stood at -117% of GDP compared to the end-2017 (-120% of GDP). Despite this, Cyprus remains at the bottom of the EU net investment list.

Deleveraging and restructuring of banking sector continues. The banking sector remains the key negative factor of the assessment and continues to constrain the creditworthiness of Cyprus. In terms of profitability, the sector ended 2017 with negative figures, when ROA stood at -1,1%. However, as of March 2018 the metric turned to positive territory and stood at around 1%. Capitalization remains solid with capital to assets ratio at 8,8% and overall solvency ratio at 15,5% as reported by the Central Bank of Cyprus as of March 2018 (see graph 5).

Despite further decline, the share of NPLs as a % of total loans remained high and stood at 42,7% as of May 2018 (45% January 2018). We expect this metric to reduce significantly in the short- and mid-term due to already mentioned restructuring of CCB. The government has already finalized a restructuring operation in the bank where it first injected capital to then create a new entity to clean-up the balance sheet by moving all the bad debt and then sell the healthy fragment of the bank to Hellenic Bank (the third largest bank on the market). This act should considerably reduce the overall level of NPLs to total loans ratio to about 30%-35%. Recent legislative changes should also make it easier for other banks to

Graph 6: Credit to the economy, % of GDP



Source: RAEX-Europe calculations based on data from the Central Bank of Cyprus and WB

reduce the levels of NPLs through securitization, restructuring and sale of loans. However, the takeover of CCB by Hellenic Bank will increase the concentration of the Cypriot banking sector.

Deleveraging of the private sector continues as the private credit to GDP ratio dropped further in 2017 to 241,3% (264,7% by end-2016). All loan segments, including households (-6%), corporates (-9%) and financial institutions (-11%) followed a downward trend y-o-y. Banks' assets to GDP ratio plunged further to around 352,4% as of end-2017 (371,6% in 2016) (see graph 6), and continued in a downward path as of 1Q 2018. Nonetheless, asset to GDP ratio remains the highest among its euro peers.

Important note for sovereign ratings

This Research Report shall be treated as a supplementary part of the published Press Release included in the following link:

https://raexpert.eu/reports/Press_release_Cyprus_05.10.2018.pdf

Both documents shall be treated as essential parts of each other.

For further information on the factors, their weights, methodologies, risks and limitations of these ratings, and other regulatory disclosures, please refer to the Press Release and the website of the Agency.